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IDDEN WELFARE SYSTEM: EXEMPTIONS, DEDUCTIONS AND CREDITS

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THE HIDDEN WELFARE SYSTEM: EXEMPTIONS, DEDUCTIONS AND CREDITS

As part of his package of tax reforms, the Minister of Finance plans to convert personal exemptions and deductions to credits in order to "make the personal income tax system fairer and more progressive".

Most adult Canadians file income tax returns and are more or less familiar with the terms exemption, deduction and credit. However, many people do not fully understand the purpose of these measures, their effects and the differences among them.

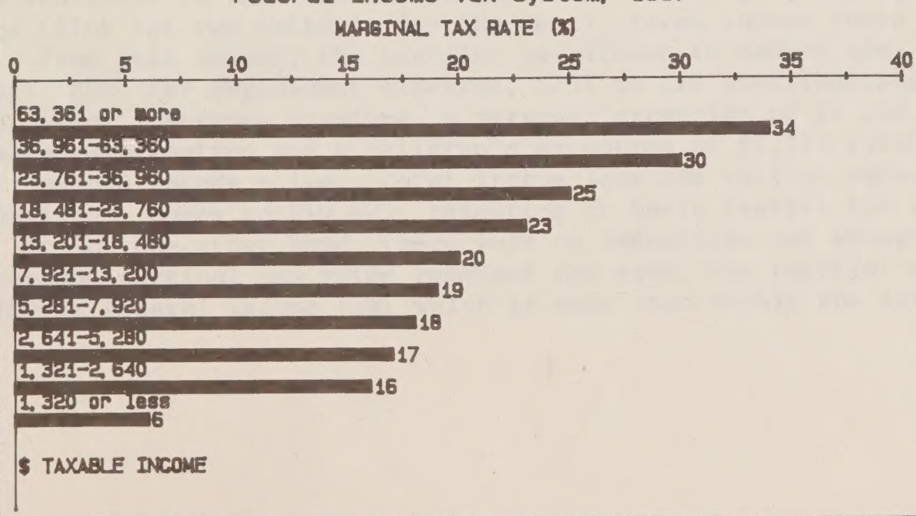
To explain how exemptions, deductions and credits operate, we must first examine the principle of ability to pay which underlies the personal income tax system.

Ability to Pay

Canada's personal income tax system is based on the principle of 'ability to pay'. The proportion of income which a person pays in federal and provincial income taxes should increase as his or her income increases.

The income tax system puts the principle of ability to pay in practice through progressive rates of taxation. Figure A illustrates this concept.

Figure A
Marginal Tax Rates and Tax Brackets,
Federal Income Tax System, 1987



Think of a taxfiler's income as a series of blocks piled one on top of the other. Income in the bottom block is taxed at a low rate, income in the next block at a higher rate, income in the next block at a higher rate still, and so on up to income in the top block which is taxed at the highest rate.

Our personal income tax system works in this manner. The federal government charges 6 percent on taxable income between $1 and $1,320, 16 percent on taxable income between 1,321 and $2,640, 17 percent on taxable income from $2,641 to $5,280 and so on up to taxable income above $63,360 which is taxed at a rate of 34 percent. **These blocks of income are called 'tax brackets' and the tax rates applied to them are known as 'marginal tax rates'. In all there are ten tax rates and brackets, as Figure A indicates.**

Suppose that a taxfiler has $5,000 in taxable income. Federal tax on the first $1,320 comes to $79 (6 percent of $1,320) and $211 on the next $1,320 (16 percent of $1,320). The taxfiler has $2,360 of taxable income left which, at a marginal tax rate of 17 percent, yields another $401 in federal income tax. In total, the taxfiler owes Ottawa $691.

The provincial income tax systems work the same way. All provinces except Quebec calculate their own income taxes as a percentage of the federal tax (ranging from 43.5 percent for Alberta to 60 percent for Newfoundland) and have the federal government collect theirs at the same time. Quebec collects its own income tax but its system is also based on the principle of ability to pay.

Exemptions and Deductions

Note that it is 'taxable income' that is subject to progressive tax rates. 'Taxable income' means total income **less** a variety of deductions and exemptions.

Take the case of a taxfiler with employment earnings of $20,000 in 1987, a spouse who works in the home and two children. Adding in the family allowance ($766 for two children for the year), total income comes to $20,766. From this amount, the taxfiler is allowed to deduct the following: $500 for employment expenses, $333 in CPP contributions, $470 in unemployment insurance premiums, a personal exemption of $4,220, a $3,700 married exemption and a children's exemption of $1,120 ($560 per child). Taxable income - i.e., total income less the various deductions and exemptions - comes to $10,423, resulting in basic federal tax of $1,690. If, on the other hand, there were no deductions and exemptions whatsoever and marginal tax rates remained the same, the taxfiler would owe $3,799 in federal income tax, which is more than double the actual amount.

Exemptions and deductions reduce the amount of income subject to tax and therefore lower the tax payable. However, they are worth more to tax-filers with higher incomes than to those with lower incomes. The reason has to do with the progressive tax rates discussed above.

Each time an individual earns an additional dollar of income, it goes into his or her highest tax bracket and is taxed at the highest applicable rate (the taxpayer's 'marginal tax rate'). In the same way, each time a dollar of income is exempted from taxation, it comes out of his or her highest tax bracket. A tax expenditure such as the married tax exemption is worth a lot to a high-income taxpayer because it reduces the slice of income which is taxed at the highest rate, and in some instances moves the taxpayer down a notch into a lower tax bracket with a lower marginal tax tax rate. While a middle-income taxpayer also can reduce his or her taxable income by the same $3,700 for a spouse who works in the home, the tax saving that results is less because his or her marginal tax rate is lower than that of the affluent taxpayer. In the case of a taxpayer whose income is already so low that he or she pays no income tax, the married tax exemption simply does not apply.

Tax Credits

Tax credits also reduce the amount of income tax payable. However, they operate differently than exemptions and deductions. There are also differences between refundable and non-refundable tax credits.

A **non-refundable tax credit** simply means an amount of tax which need not be paid. For example, suppose the government wanted to provide tax relief to each wage-earner in Canada. It could institute a $500 Wage-Earner Tax Credit. Anyone with employment earnings would calculate his or her income tax in the usual manner but because of the credit would not have to pay the first $500. If a person's gross tax were $500 or less, the tax credit would reduce the amount owed to zero. If the taxfiler's gross tax were more than $500, he would get a tax reduction equal to $500.

A non-refundable tax credit, such as our hypothetical Wage-Earner Tax Credit, provides the same tax saving to everyone whose gross tax is at least equal to the amount of the credit. A taxfiler with gross income tax of $600, for instance, would receive the same $500 benefit as someone who owed $10,000 in income tax. However, those with gross tax below $500 would get smaller Wage-Earner Tax Credits. Someone with gross tax of $300 would get a Wage-Earner Tax Credit of $300, reducing tax payable to zero. However, those whose earnings are so low that they already do not owe income tax would receive nothing from a non-refundable tax credit such as the one in our example.

A **refundable tax credit**, by contrast, does benefit the poor. Suppose we had a $500 Refundable Wage-Earner Tax Credit. Someone whose gross tax is $200 would have his or her tax bill reduced to zero. In addition, he would receive a cheque from the government for the remaining $300 in benefits. If a worker owed no gross tax, he would get a cheque for $500.

There is a further variation on the tax credit. A **diminishing refundable tax credit** pays its maximum benefit to recipients with incomes below a certain level, a partial benefit (which decreases as income increases) to those with higher incomes, and no benefit at all to those above a certain point.

In fact the federal government offers two refundable tax credits and they are both of the diminishing type. The child tax credit, enacted in 1978, pays $484 per child for the 1987 tax year to families with net income up to $23,500; the credit is reduced by 5 cents for every dollar of income above this amount, disappearing to zero once income passes a certain point (e.g., $42,860 for a family with two children). The 1986 Budget brought in a sales tax credit worth $50 per adult and $25 per child for families with net income below $15,000; the sales tax credit is reduced by 5 cents for every dollar of income above this point, disappearing past a certain level (e.g., $18,000 for a couple with two children).

Who Gets What

Exemptions, deductions and credits all lighten the tax load. Refundable tax credits, in addition, pay benefits to lower-income Canadians who pay little or no income tax. However, the way these tax measures operate determines the amount of benefits they deliver to people at different income levels.

Table 1 compares the benefits from three tax relief measures designed to help families with children. The children's tax exemption is $560 per child for the 1987 tax year. The child care expense deduction allows a single parent or the spouse with the lower income in a couple to deduct from taxable income up to $2,000 per child under 14, to a limit of $8,000 per family, for receipted child care expenses incurred to allow the tax-filer to work or take a training course. The child tax credit, as explained above, goes to low and middle-income families with children; we show the $454 per child credit for the 1986 tax year, payable in 1987.

Table 1

Value of Three Child Tax Benefits, Two-Earner Couple With Two Children, by Family Earnings, 1987

Employment Earnings	Children's Tax Exemption	Child Care Expense Deduction	Child Tax Credit	Total
$ 0	$ 0	$ 0	$908	$ 908
10,000	103	341	908	1,352
20,000	308	798	908	2,014
30,000	343	948	903	2,194
40,000	394	1,086	442	1,922
50,000	428	1,153	80	1,661
80,000	514	1,333	0	1,847
100,000	514	1,450	0	1,964

Note

The child tax credit is for the 1986 tax year, payable in 1987. The other two benefits are for the 1987 tax year and show federal tax savings only.

The pattern of benefits is clear. The exemption and the deduction provide tax savings that rise with income. The credit works in the opposite direction.

Two-earner couples with two children and no employment earnings receive no benefit from the children's tax exemption and child care expense deduction because they are below the taxpaying threshold. They get the maximum child tax credit of $908.

The families in our example earning between $10,000 and $50,000 benefit from all three child-related benefits, though in differing amounts. The $10,000 family, for example, gets twice as much from the child tax credit ($908) as it saves in federal income taxes from the other two benefits combined ($444). The $50,000 family, on the other hand, benefits more from the child care expenses deduction ($1,153 in federal tax savings) and the children's tax exemption ($428) than it does from the child tax credit ($80).

The $80,000 and $100,000 families shown in Table 1 do not qualify for the child tax credit because their incomes are too high. However, they benefit substantially from the children's tax exemption and the child care expense deduction. In fact, even though they do not get the child tax credit, they enjoy higher total benefits than the two poorest families. The $100,000 family's tax savings from the exemption and

deduction come to $1,964 in contrast to the $908 child tax credit for the family with zero earnings and the $1,352 in benefits from all three programs for the $10,000 couple.

Exemptions and deductions are regressive, which means they benefit lower-income Canadians least and the affluent the most. Refundable tax credits are progressive, which means they pay their highest benefit to those with low incomes.